State Notes

TOPICS OF LEGISLATIVE INTEREST

Winter 2015

The Long and Winding Road: Proposal 1 and Road Funding Reform
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On May 5, 2015, Michigan voters will have the choice to approve or reject Proposal 1, which would increase the sales tax ceiling from 6.0% to 7.0%. However, the voters' decision will affect much more than the sales tax – there are a number of other measures in a recently passed transportation funding reform package that will take effect only upon voter approval of Proposal 1. These bills cover a variety of reforms that would affect fuel taxation, road construction warranty requirements, the earned income tax credit, State trunkline debt service, the School Aid Fund, and vehicle registration fees, among other items.

The purpose of this article is to provide background on the road funding situation, details on the key provisions of the reform package, and a look at the comparative tax burden at the gas pump under current law as well as the reform package, and address some common questions regarding the transportation funding package.

Background: Road Funding Situation

Recently, it has become generally accepted that Michigan's road and bridge infrastructure is suffering from funding shortfalls. Roads and bridges at the State and local levels have been deteriorating, are receiving proportionately less funding than in the past, and will become exponentially more expensive to repair as crucial maintenance is delayed. The Michigan Department of Transportation (MDOT) has indicated that an immediate increase of over $1.1 billion is needed to bring most State roads and bridges up to good or fair condition by 2025.[1] The amount of additional funding that local road agencies may need is a difficult question and the focus of much debate.

State revenue for transportation is primarily driven by vehicle registration fees and motor fuel taxes. Table 1 compares select State revenue in transportation for fiscal year (FY) 1997-98 (adjusted for inflation based on the Consumer Price Index) and FY 2013-14. Since the last fuel tax increase took effect in FY 1997-98, that year serves as a good basis of comparison.

Table 1

State Revenue Comparison:
Fuel Taxes & Registration Fees, FY 1997-98 & FY 2013-14

State Revenue Source	FY 1997-98 (adjusted for inflation)	FY 2013-14	% Change
Fuel Taxes	$1.5 billion	$938.0 million	37.4% decrease
Vehicle Registration Fees...............	$978.1 million	$939.5 million	4.0% decrease
Total	**$2.5 billion**	**$1.9 billion**	**24.0% decrease**

Although Table 1 shows a 24.0% decrease in fuel tax and vehicle registration fee revenue from FY 1997-98 to FY 2013-14, this is not to say that there has been a 24.0% decrease in State revenue altogether. When General Fund dollars are considered ($0 in FY 1997-98 and $336.6 million in FY 2013-14), the funding decrease from FY 1997-98 to FY 2013-14 is 12.0%. Historically, it was extremely unusual for General Fund dollars to fund transportation. However, since transportation revenue in

[1] According to an MDOT presentation on the state of road funding that was given at the State Transportation Commission hearing in July 2014.

recent years has been insufficient to maximize Federal match dollars, the State has been forced to rely on General Fund dollars to make up the difference.

As Table 1 illustrates, the primary reason for decreased revenue lies within diminishing fuel tax receipts. This is caused by increases in vehicle fuel economy, which result in lower consumption, and inflation. The gasoline tax rate of 19 cents per gallon was set in 1997. Accounting for inflation, 19 cents in 1997 would equal roughly 28 cents today. Looked at another way, today's 19-cent gas tax would equal 13.5 cents in 1997 – meaning that the gas tax burden has effectively decreased since the last rate increase 18 years ago. As to fuel economy, the average fuel economy for a model 1997 vehicle was 24.6 miles per gallon, while the average fuel economy for a model 2014 vehicle was 31.6 miles per gallon. This increase in fuel economy affects the amount of fuel consumed, and fewer gallons of gasoline consumed directly translate to less revenue for roads. The combination of inflation and decreasing fuel consumption has resulted in a significant drop in fuel tax revenue and buying power.

Proposal 1 and the Transportation Reform Package: What It Would Do

Simply put, the transportation reform package effectively would draw a bright line between taxing fuels and all other goods. In the process, it would alter sales tax and fuel tax provisions, and raise revenue for transportation, schools, and local governments. Central to the transportation reform package is House Joint Resolution UU (Proposal 1).

House Joint Resolution (HJR) UU would amend the State Constitution to raise the sales tax ceiling from 6.0% to 7.0%, and requires a vote of the people. This amendment is at the center of the proposal due to various tie-bars throughout the reform package (meaning that other legislation will not take effect unless the voters approve HJR UU). At its core, the package would do the following:

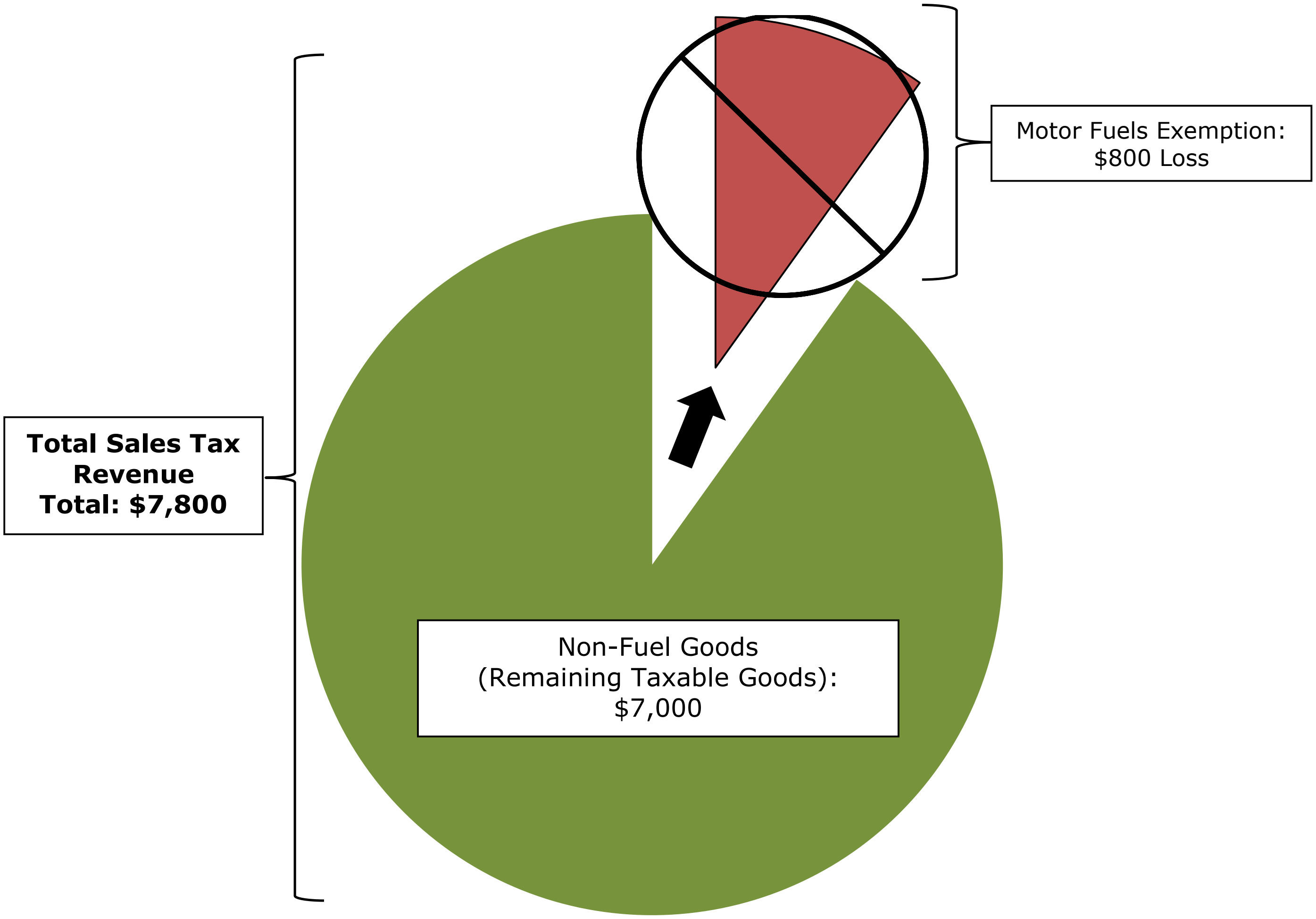
- Eliminate the sales tax on motor fuels.
- Increase the sales tax on non-fuel goods from 6.0% to 7.0%.
- Direct a portion of the use tax revenue to the School Aid Fund.
- Increase the Earned Income Tax Credit (EITC) from 6.0% to 20.0% of the Federal EITC.
- Change the current 19-cents-per-gallon gasoline tax to an annually adjusted rate that would be based on 14.9% of the average wholesale price of gasoline.
- Direct a portion of new transportation revenue to pay down MDOT debt service by approximately $1.2 billion out of $2.0 billion total over the next two years.

Figures 1-4 offer illustrations and explanations of the dynamics of the points discussed above. A comprehensive table (Table 3) at the end of this article details the estimated fiscal impact of the entire package. For a more comprehensive look at the provisions of the package, please see the Senate Fiscal Agency's analysis of House Joint Resolution UU (Proposal 1) and the related legislation.[2]

The exemption of motor fuels from the sales tax would result in a revenue loss of about $800.0 million to public transit, the School Aid Fund, revenue sharing, and the General Fund. However, the sales tax increase on remaining goods would generate roughly $1.4 billion, resulting in a net increase in State revenue for these areas of about $600.0 million. Figures 1 and 2 illustrate this in more detail.

[2] http://www.legislature.mi.gov/documents/2013-2014/billanalysis/Senate/pdf/2013-SFA-HJRUU-N.pdf

Figure 1
Exempting Motor Fuel Purchases from Sales Tax
(Dollars in Millions)



Step 1: Motor Fuels Exempted from the Sales Tax

This would reduce sales tax revenue by approximately $800 million.

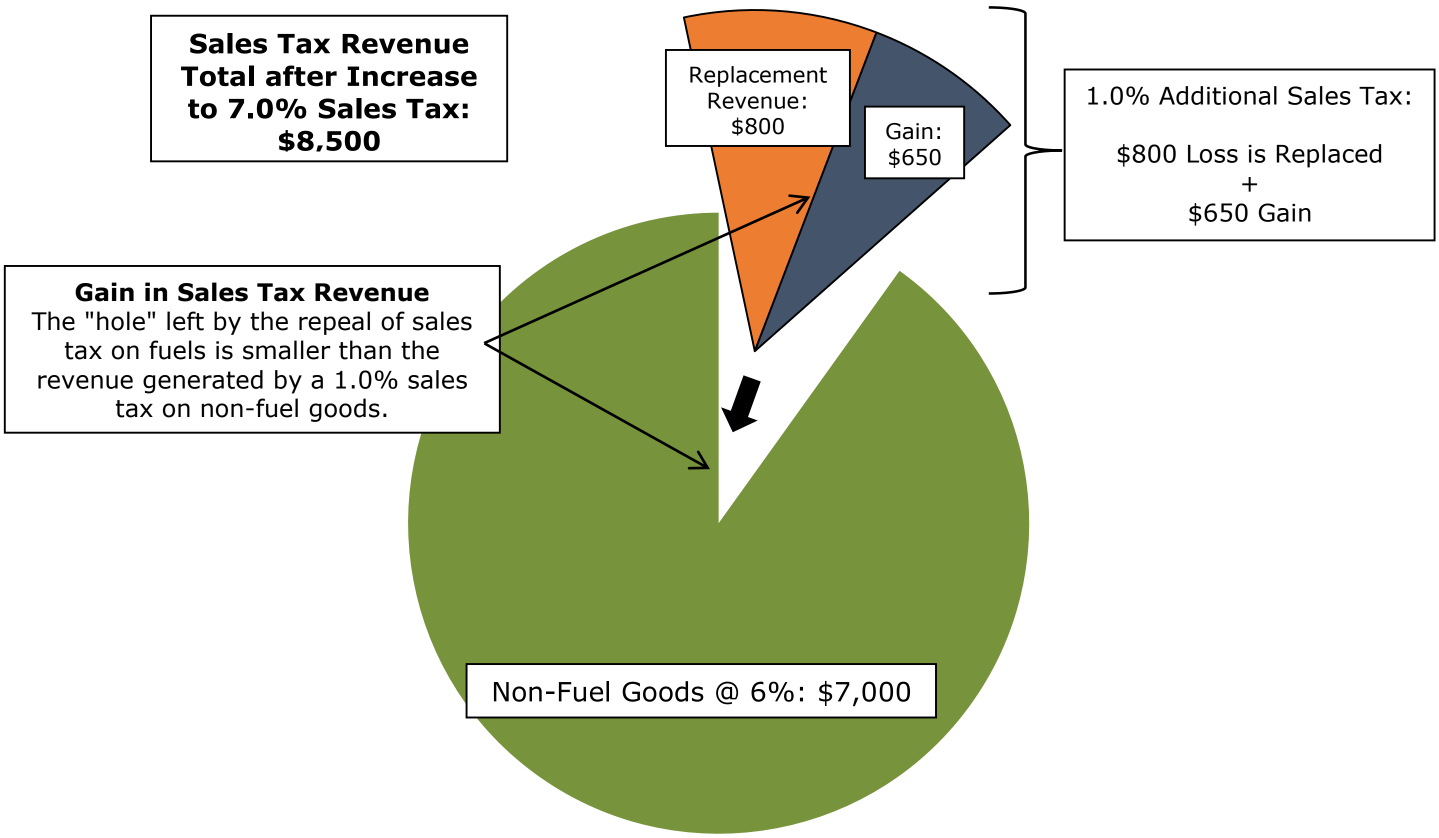
This would result in the following losses (in millions):

- School Aid Fund	($570)
- Revenue Sharing	($100)
- General Fund	($100)
- Comprehensive Transportation Fund (CTF)	($30)

Some of these losses would be replaced. See Figure 2.

This step would not have any effect on road funding.

Figure 2
Sales Tax Increase from 6.0% to 7.0% on Non-Fuel Goods:
Replacing & Increasing Sales Tax Revenue for Schools, Revenue Sharing, & General Fund
(Dollars in Millions)



Step 2: Sales Tax Increased to 7%; Use Tax Redirection; EITC Increase

This would increase sales tax revenue by approximately $1.4 billion for a net gain of $650.0 million. It also would redirect $150.0 million of the use tax from the General Fund to the School Aid Fund, and $260.0 million General Fund toward the Earned Income Tax Credit.*

This would replace the losses in Step 1 & result in the following net gains (in millions):

- School Aid Fund	$300
- Revenue Sharing	$100
- General Fund	$16

CTF (Public Transit) would see a net loss of $20.0 million, but would see further increases under the fuel tax increase. See Figure 3C for net CTF gains under the reform package.

This step would not have any effect on road funding.

**These estimates reflect only key provisions of the entire reform package. See Table 3 for a comprehensive fiscal analysis.*

As noted above, the reform package includes fuel tax changes. The State taxes levied on gasoline include $0.19 per gallon in fuel tax and $0.19 per gallon in sales tax (based on a $3.50 per gallon retail price). The fuel tax revenue is directed to transportation and distributed according to statute, but revenue from the sales tax on fuels is directed to schools, local governments via revenue sharing, public transit, and the General Fund.

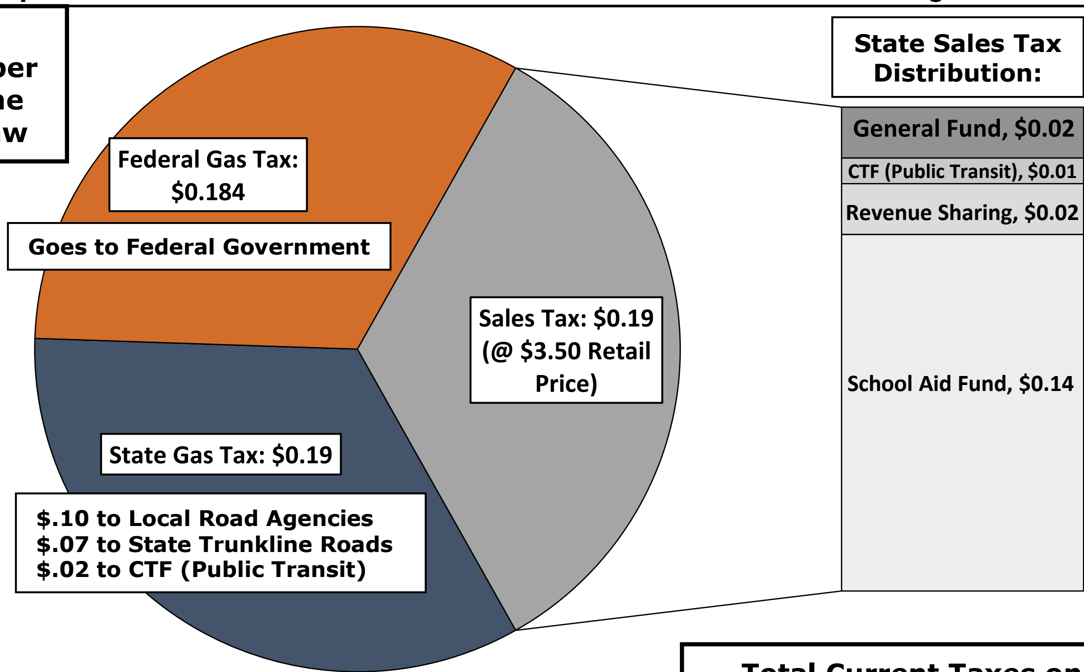
While the provisions described in Figures 1 and 2 above would repeal the sales tax on fuels, Figures 3A and 3B illustrate the gas tax increase. At a retail price of $3.50 per gallon, the $0.19 per gallon sales tax effectively would be replaced by an additional $0.23 per gallon in "new" gas tax. The end result would have all State taxes paid at the pump directed to transportation.

If the voters were to approve Proposal 1 and the reform package took effect, the gas tax would be 42 cents per gallon beginning October 1, 2015, and would be adjusted every October based on the rolling 12-month average wholesale price. The initial tax of 42 cents is based on an average wholesale price of $2.82 per gallon. Large year-to-year fluctuations in gas prices would not have a significant impact on the gas tax, however, since annual adjustments would be capped at the lesser of a 5.0% change in fuel price or inflation. The diesel fuel tax would be revised from $0.15 per gallon to 14.9% of diesel fuel average wholesale prices as well. Under the new fuel tax rates, Michigan Transportation Fund (MTF) would see an increase of approximately $1.2 billion in FY 2015-16.[3] The reform package includes various other revenue increases for transportation as well, for a grand total of approximately $1.3 billion in additional transportation revenue in FY 2015-16.

[3] This calculation is based on MTF revenue prior to appropriations to the CTF and other earmarks under the MTF law, Public Act 51 of 1951 (MCL 247.660).

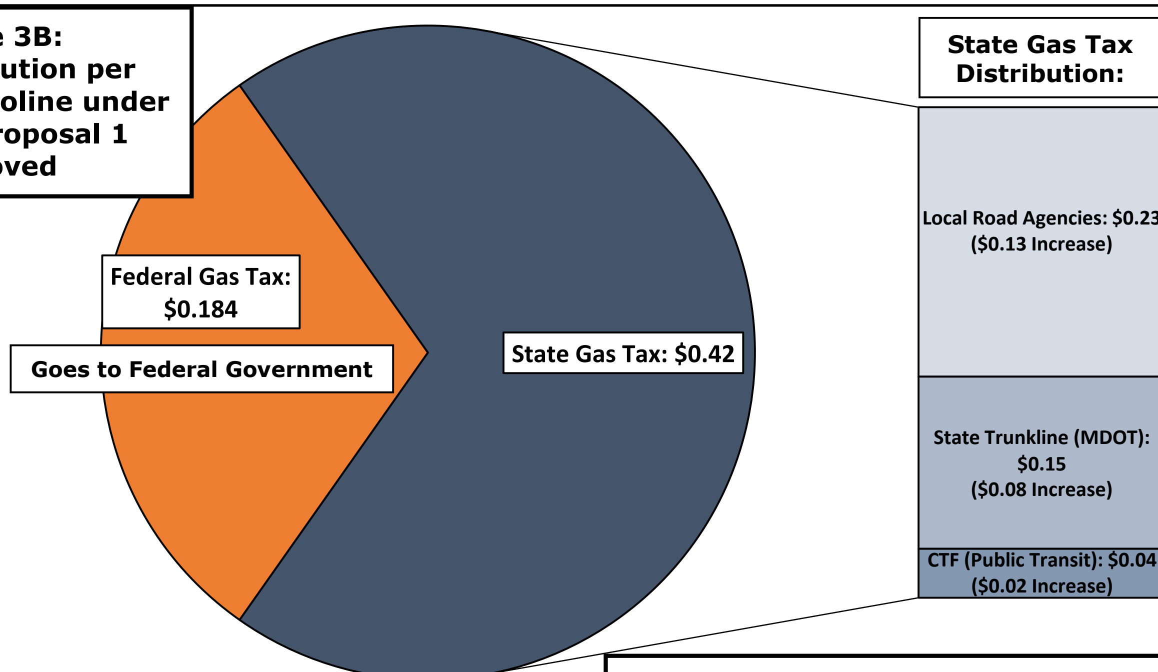
Figures 3A-3B
Increasing the Fuel Tax: Where Taxes on Fuels Go
Comparison of Gas Taxation under Current Law vs. the Reform Package

Figure 3A: Tax Distribution per Gallon of Gasoline under Current Law



Total Current Taxes on Gasoline: $0.564 per Gallon

Figure 3B: Tax Distribution per Gallon of Gasoline under Reform/Proposal 1 Approved



Total Tax on Gasoline @ $2.82 Wholesale under Reform: $0.604 per Gallon

It is important to note that under the reform package, any new revenue in excess of $800.0 million in FY 2015-16 and $400.0 million in FY 2016-17 would be directed to pay down existing transportation debt.[4] This means that road agencies would not realize the "total" revenue increases under the reform package until FY 2017-18. Table 2 presents the approximate distribution of "new" transportation revenue that would be generated under the reform package.

Table 2

Transportation Funding under Reform/Proposal 1: Net Estimated Additional Revenue Distributions (in Millions)

	FY 2015-16	FY 2016-17	FY 2017-18
State Trunkline (MDOT)	$180	$350	$575
Local Road Agencies	280	540	900
CTF (Public Transit)	25	70	125
Debt Service Payment	815	440	0
Total Increase	**$1,300**	**$1,400**	**$1,600**

Common Questions about Proposal 1 and the Reform Package

Question #1:
Is Proposal 1 a sales tax increase to pay for roads?

*The increase for road funding would stem from a fuel tax increase, **not** the sales tax increase. The sales tax on fuels would be eliminated.*

The State sales tax does not currently fund roads, and would not fund roads under the reform package. The sales tax on motor fuels would be repealed under the plan. This tax currently funds schools, local units of government, the General Fund, and public transit – but not roads.

The revenue generated from raising the sales tax to 7.0% would not be dedicated to roads. It would replace the revenue losses to schools, local units, the General Fund, and public transit, while increasing funding for these areas (with the exception of the CTF).

Effectively, the proposal would shift the sales tax burden from motor fuels to other goods, and also would provide an overall increase in sales tax revenue. The sales tax components of the reform package would not have any bearing on road funding. Under Proposal 1, all State taxes paid at the pump would go to transportation funding. Under current law, at a pump price of $3.80 per gallon, one-half of State taxes (the fuel tax) goes to transportation funding, and the other half (the sales tax) goes to schools, local governments, and the general fund.

Question #2:
Would Proposal 1 result in higher taxes at the gas pump?

The comparative tax burden per gallon of gasoline would depend on the retail price of gas at the time of purchase and the 12-month average wholesale price of gas for the fiscal year.

[4] According to MDOT, current transportation indebtedness is roughly $2.0 billion.

Estimates throughout governmental agencies as well as the press regarding the tax burden difference for FY 2015-16 have varied between $0.03 and $0.12 per gallon – but this is attributable to the use of different fuel prices for each calculation.

The current sales tax on gasoline is based on 6.0% of the *retail* price *at the time of purchase*. This means that the sales tax on gas can change from purchase to purchase, depending on the where and when gas is purchased. However, the motor fuel tax under the reform package would change only every 12 months, and would be based on the *12-month average wholesale* price of gasoline. The adjustment limitation of 5.0% or the level of inflation also would mitigate changes in the fuel tax relative to price shifts. As a result, if there were a spike in the retail price of gas, the tax burden under the reform package likely would be less than under current law.

It is possible, even likely, that the fuel tax burden in future years could be lower than under current law. This is because, while the retail price of gas tends to increase over time, despite the occasional dip, the basis for the fuel tax (the average wholesale price) would be locked in for 12 months and subject to caps on adjustments.

Figures 4A and 4B illustrate the comparative tax burden at the pump at different retail prices. The first scenario shows that in FY 2015-16, at a retail price of $2.00 per gallon, the reform package would result in a higher tax rate at the pump of $0.13 per gallon. The second scenario shows the reform package burden at $0.04 less than current law at $5.00 per gallon.

The lower the average wholesale price of fuel is in proportion to the retail price at the time of purchase, the lower the comparative tax burden would be under the reform package. For example, at $4.00 per gallon, the reform package would be tax-burden neutral as to gasoline – the sales tax would be $0.19 per gallon under current law, while the gas tax would be $0.19 more per gallon under the reform package. Given that the current 2014 average retail price of gasoline was $3.80, it is likely that the reform package would not have a substantial impact on pump prices in the aggregate.

Figure 4A: Tax Burden at $2.00 per Gallon
Current Law vs. Reform Package (FY 2015-16)
Gasoline Price: $2.00/Gallon Retail, $2.82 Avg Wholesale

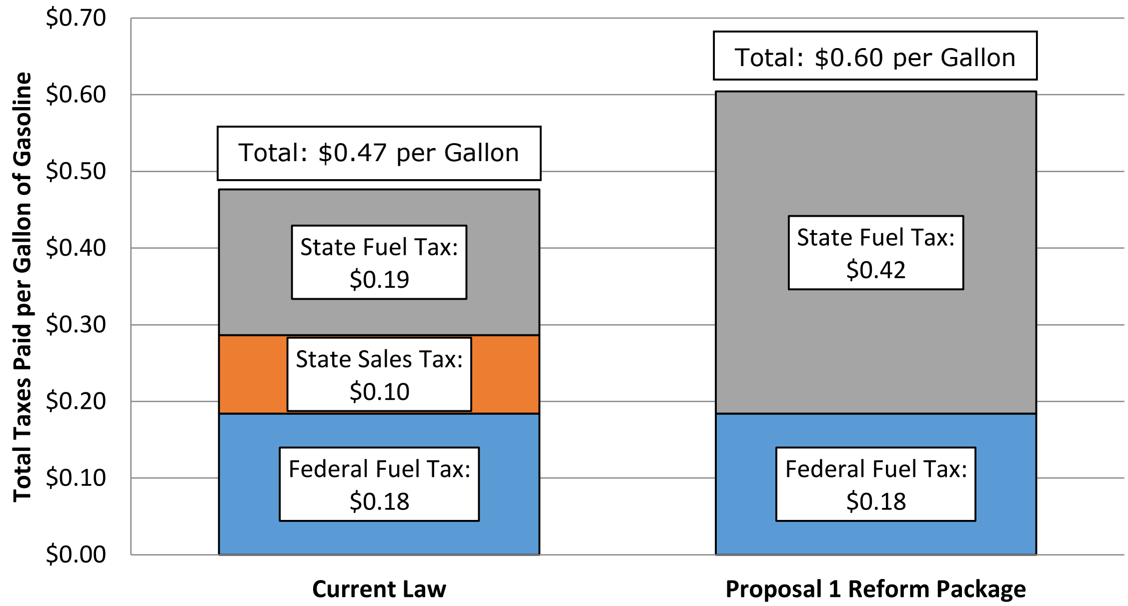
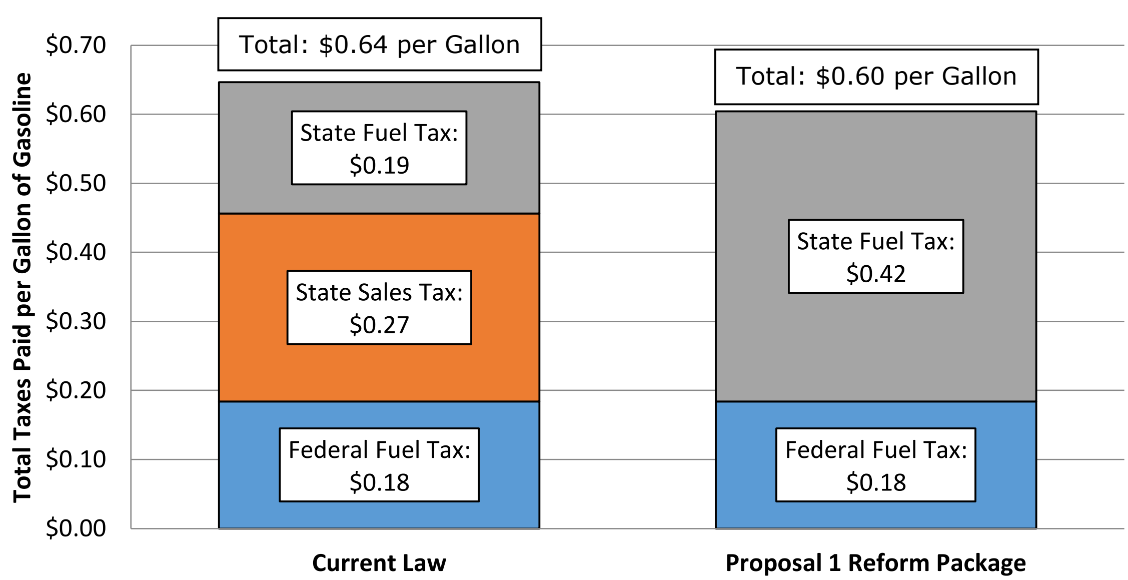


Figure 4B: Tax Burden at $5.00 per Gallon
Current Law vs. Reform Package (FY 2015-16)
Gasoline Price: $5.00/Gallon Retail, $2.82 Avg Wholesale



Question #3:
Could the revenue raised by the fuel tax increase be directed to areas other than transportation and road funding, or go to fund projects that are unrelated to roads?

Under the State Constitution, all fuel and registration taxes must be used for transportation purposes – and at least 90% must be used specifically for roads. Additionally, road funding is distributed according to a statutory formula, which offers little opportunity for direction to unrelated projects.

Article 9, Section 9 of the State Constitution states the following (emphasis added):

> "*All specific taxes* … *on fuels* sold or used to propel motor vehicles … shall… be used *exclusively for transportation purposes*…
>
> "Not less than *90 percent* … shall… be used *exclusively* for the transportation purposes of planning, administering, constructing, reconstructing, financing, and maintaining state, county, city, and village *roads, streets, and bridges*…
>
> "*The balance*, if any … shall be used *exclusively for* the transportation purposes of *comprehensive transportation*…".

Simply put, it would be unconstitutional for less than 90% of the revenue generated from the fuel tax increase, or vehicle registration fee increases, to be used for roads. Further, it would be unconstitutional for any remainder to be used for anything other than comprehensive transportation purposes (public transit, aeronautics, and rail).

With regard to the unrelated projects, Public Act 51 of 1951 (PA 51) contains the statutory formula that determines where transportation funding goes. Generally speaking, 10.0% of the revenue goes to the CTF. Of the remainder, 39.1% goes to MDOT, 39.1% goes to county road agencies, and 21.8% goes to cities and villages. The formula calculates disbursements to individual local road agencies based on readily quantifiable data such as population, vehicle registrations, and urban and primary lane miles. Absent amendments to PA 51, new transportation revenue under the plan would have to follow the existing PA 51 formula.

While the Legislature may include budget provisions to allocate funds to specific road projects, those funds still must be directed and used according to the terms of the Constitution and statute. The Michigan Department of Transportation and local road agencies must abide by the rules when spending the fuel tax and vehicle registration tax revenue. The same rules that now apply to road funding would continue to apply to the new revenue generated under the reform package. The reform package would have no substantive change on distribution or spending rules.

Conclusion

From a budgetary standpoint, the transportation reform package would result in increases in transportation funding, the School Aid Fund, constitutional revenue sharing, and the General Fund. The plan would result in an increase in motor fuel tax revenue that would more than account for inflation since the last gas tax increase to 19 cents per gallon in 1997. As gasoline consumption continues to decline in future years, revenue from gasoline taxes will continue to decrease accordingly. However, these negative effects would be somewhat mitigated since the tax would be based on the average wholesale price of gasoline, which has tended to increase over time.

Additionally, the reform package could indirectly affect a number of other budgets. If Proposal 1 fails, and if the past several years are any indication, roughly $150.0 million in additional transportation funding will be needed to maximize Federal match dollars. Typically, Federal match funding in recent years has been maximized through the appropriation of General Fund dollars to transportation. These General Fund appropriations to transportation come at the expense of various other budget areas. If Proposal 1 is approved, the increase to State trunkline funding likely should be sufficient to maximize Federal match dollars in FY 2016-17 – even when considering the earmark of a portion of new revenue to paying down debt service. In FY 2015-16, General Fund appropriations will be required to maximize Federal match dollars, regardless of the outcome of Proposal 1.

From the standpoint of infrastructure demands, it is unclear what effects the reform package would have. With regard to the State trunkline, which does not include roads under local control, MDOT has indicated that it needs an additional $1.1 billion in immediate funding to meet infrastructure goals by 2025. Under the reform plan, due to the debt repayment mandate, the additional revenue gained by MDOT would be approximately $180.0 million in FY 2015-16 and $348.0 million in FY 2016-17, and would stabilize around $573.0 million in FY 2017-18. As a result, this likely would push back the 2025 goal date, and perhaps MDOT would adjust its road condition goals due to funding restraints. The tradeoff for delaying funding increases would not necessarily be year-for-year – a year of maintenance delay on the front end would result in a longer delay on the back end. Local road agencies would see an increase, but since their funding needs are less clear, it is difficult to predict whether Proposal 1 would generate enough funds to satisfy local road needs.

From the consumer and taxpayer standpoint, the provision of the reform package that would have the most impact is the sales tax increase. The sales tax increase on nonfuel goods from 6.0% to 7.0% would increase the cost of purchasing these goods. On the other hand, the fuel tax increase combined with the repeal of sales tax on fuels would result in a nominal difference for those buying fuel at the pump.

From a policy standpoint, the reform package would represent a shift for the State in drawing a line between motor fuels and other commodities. All taxes on fuel would go to transportation and roads, whereas taxes paid at the pump currently go to roads, schools, local governments, and the General Fund.

Table 3
Estimated Impact of Transportation Package as Passed by Legislature
Tax and Vehicle Registration Changes
(dollars in millions)

Tax/Registration Change	FY 2015-16	FY 2016-17	FY 2017-18
Increase Tax Credits (SB 847)			
Increase Earned Income Tax Credit	$0.0	($260.8)	($267.4)
Increase Homestead Prop. Tax Credit for Low Income Seniors	$0.0	($0.3)	($0.3)
Total	$0.0	($261.1)	($267.7)
General Fund	$0.0	($261.1)	($267.7)
Exempt Gas from Sales/Use Tax (HB 4539/HB 5492)			
School Aid Fund	($567.1)	($557.5)	($568.0)
Comprehensive Transportation Fund	($35.7)	($35.1)	($35.7)
Constitutional Revenue Sharing	($76.7)	($75.4)	($76.8)
General Fund	($96.7)	($95.2)	($97.1)
Total	($776.2)	($763.2)	($777.7)
Increase Sales Tax (Sales other than gasoline/diesel fuel) (HJR UU)			
School Aid Fund	$708.6	$732.6	$754.7
Comprehensive Transportation Fund	$16.5	$17.0	$17.5
Constitutional Revenue Sharing	$177.1	$183.2	$188.7
General Fund	$524.4	$541.2	$557.5
Total	$1,426.6	$1,474.1	$1,518.4
Use Tax Earmark to School Aid Fund (HB 5492/HJR UU)	$151.1	$155.6	$160.3
General Fund	($151.1)	($155.6)	($160.3)
Establish Affiliate Nexus (SB 658/SB 659)			
School Aid Fund	$44.0	$45.5	$46.8
Constitutional Revenue Sharing	$6.0	$6.2	$6.4
General Fund	$10.0	$10.3	$10.6
Total	$60.0	$62.0	$63.9
Restructure Motor Fuel Tax (HB 5477/HB 5493)			
Michigan Transportation Fund	$400.0	$800.0	$1,352.3
Comprehensive Transportation Fund	$40.0	$80.0	$135.2
MDOT Debt Service	$814.7	$456.2	$0.0
Recreation Account (Legacy Fund)	$24.8	$25.6	$27.6
Total	$1,239.5	$1,281.8	$1,379.9
Vehicle Registration (HB 4630)			
Truck Registrations	$50.0	$50.0	$50.0
Depreciation/Discount Elimination	$10.9	$41.0	$62.0
Total	$60.9	$91.0	$112.0
Michigan Transportation Fund	$60.9	$91.0	$112.0
Comprehensive Transportation Fund	$6.1	$9.1	$11.2
Net Impact of Changes			
Michigan Transportation Fund	$460.9	$891.0	$1,464.3
Comprehensive Transportation Fund	$26.9	$71.1	$128.3
MDOT Debt Service	$814.7	$456.2	$0.0
Recreation Account (Legacy Fund)	$24.8	$25.6	$27.6
School Aid Fund	$336.5	$376.2	$393.8
Constitutional Revenue Sharing	$106.4	$114.0	$118.3
General Fund	$286.6	$39.6	$43.1
Total	$2,029.9	$1,902.6	$2,047.0

Prepared by: Michigan Senate Fiscal Agency, April 15, 2015